

# **REDUCING ENTITLEMENT SPENDING**

**The Congress of the United States  
Congressional Budget Office**

---

### NOTE

Numbers in the tables and text of this report may not sum to totals because of rounding.

---

---

# Preface

**T**his study analyzes three ways to realize budgetary savings by taxing or reducing benefits from entitlement programs considered as a group, rather than reducing benefits program by program. The Congressional Budget Office (CBO) prepared the study in response to requests from Members of Congress and others for an elaboration of the analysis presented on this subject in CBO's March 1994 volume *Reducing the Deficit: Spending and Revenue Options*. The study also examines the current distribution among family income groups of benefits from 11 major entitlement programs, in response to a request from Senator Alan K. Simpson and eight other Senators for information on current payments to individuals and families under these entitlements.

The specific options considered are taxing all entitlement benefits under the federal individual income tax, reducing benefits provided to middle- and high-income families, and denying benefits to families with the highest incomes. For each option, the study estimates budgetary savings and the distributional impact on families; it also discusses issues that would affect the options' administration and effectiveness. In accordance with CBO's mandate to provide objective and impartial analysis, this study contains no recommendations.

Roberton Williams of CBO's Tax Analysis Division wrote the study under the direction of Rosemary Marcuss and Frank Sammartino. Paul Cullinan of the Budget Analysis Division helped write the first draft of the study. Richard Kasten assisted in developing the micro-simulation model used to analyze the policy options. Roger Hitchner of the Natural Resources and Commerce Division drafted the discussion of agricultural subsidies. Many other CBO staff members provided comments including Robert Dennis, Nancy Gordon, Mark Musell, Neil Singer, Ralph Smith, David Torregrosa, and David Weiner. Eugene Steuerle and Patricia Ruggles offered useful comments on a late draft.

Leah Mazade edited the manuscript, and Christian Spoor provided editorial help during the production process. Simone Thomas produced drafts of the study. Martina Wojak-Piotrow prepared the study for publication.

Robert D. Reischauer  
Director

September 1994



---

# Contents

	SUMMARY	ix
ONE	INTRODUCTION	1
	The Major Entitlement Programs	2
	Approaches to Reducing Entitlement Spending	4
TWO	THE MAJOR ENTITLEMENTS: WHO GETS THEM AND SHOULD THEY BE MEANS-TESTED?	7
	Cash Social Insurance Programs	7
	Federal Civilian and Military Retirement Programs	16
	Means-Tested Income Support Programs	20
	Government-Sponsored Health Insurance	25
	The Distribution of All Entitlement Benefits	29
THREE	OPTIONS FOR CURTAILING ENTITLEMENTS AND THEIR EFFECTS ON THE BUDGET	31
	Make Entitlements Subject to the Individual Income Tax	31
	Reduce Entitlements for Middle- and High-Income Recipients	34
	Deny Entitlements to High-Income Recipients	36
FOUR	DISTRIBUTIONAL EFFECTS	39
	Effects on Different Types of Families	40
	Effects Among Programs	41
FIVE	IMPLEMENTING A GLOBAL MEANS TEST	47
	Administering Agency	47
	Should a Means Test Be Prospective or Retrospective?	49
	Type of Unit	50
	Measuring Resources	51
	Taxing or Reducing In-Kind Benefits	52
	Rate of Benefit Reduction	53
SIX	COMPARING THE POLICY OPTIONS	55

## APPENDIXES

- A Calculating Budgetary Savings and Distributional Effects 61
- B Budgetary Savings and Distributional Effects of  
Options with Equivalent Budgetary Savings 63

## TABLES

- S-1. Recipient Families by Income and Type, 1990 x
- S-2. Estimated Gains in Revenues and Reductions in Spending  
Under Three Policy Options to Cut Net Entitlement Costs,  
Fiscal Years 1995-1999 xiii
- S-3. Distribution of Losses of Benefits Among Recipient Families  
Under Three Policy Options to Cut Net Entitlement Costs,  
by Family Income and Type xiv
1. CBO Baseline Projections of Mandatory Federal Spending  
by Program, Fiscal Years 1993 and 1999 3
2. Average Social Security and Railroad Retirement Benefits per  
Recipient Family Before and After Federal Income Taxes,  
by Family Income and Type, 1990 9
3. Percentage of Families Receiving Cash Benefits,  
Average Benefits per Family, and Benefits as a Percentage of  
Family Income, by Program, Family Income,  
and Family Type, 1990 10
4. Average Unemployment Compensation per Recipient Family  
Before and After Federal Income Taxes, by Family Income  
and Type, 1990 14
5. Percentage of Families Receiving Federal Civilian and Military  
Pensions, Average Pension per Recipient Family, and Pensions  
as a Percentage of Family Income, by Program, Family  
Income, and Family Type, 1990 17
6. Average Federal Civilian and Military Pensions per Recipient  
Family Before and After Federal Income Taxes, by Family  
Income and Type, 1990 19
7. Percentage of Families Receiving Means-Tested Benefits,  
Average Benefits per Recipient Family, and Benefits  
as a Percentage of Family Income, by Program, Family Income,  
and Family Type, 1990 22

---

8.	Percentage of Families Receiving the Earned Income Tax Credit, Average Credit per Recipient Family, and Credit as a Percentage of Family Income, by Family Income and Type, 1990	24
9.	Percentage of Families Receiving Health Benefits, Average Value per Recipient Family, and Benefits as a Percentage of Family Income, by Program, Family Income, and Family Type, 1990	26
10.	Characteristics of Families Receiving Entitlement Benefits, by Family Income and Type, 1990	28
11.	Additional Federal Revenues from Broadening Taxable Income to Include Entitlements, Fiscal Years 1995-1999	33
12.	Budgetary Savings from Reducing Entitlement Benefits for Middle- and High-Income Recipients, Fiscal Years 1995-1999	36
13.	Budgetary Savings from Denying Entitlement Benefits to High-Income Recipients, Fiscal Years 1995-1999	37
14.	Percentage of Recipient Families Losing Benefits Under Three Policy Options to Cut Net Entitlement Costs, by Family Income and Type	40
15.	Distribution of Budgetary Savings Under Three Policy Options to Cut Net Entitlement Costs, by Family Income and Type	41
16.	Percentage of Average Benefits Lost by Families Losing Benefits Under Three Policy Options to Cut Net Entitlement Costs, by Family Income and Type	42
17.	How Three Policy Options to Cut Net Entitlement Costs Affect the Benefits Lost by Recipient Families, by Program	44
18.	Comparing the Effects of Three Policy Options to Cut Net Entitlement Costs	56
B-1.	Estimated Gains in Revenues and Reductions in Spending Under Three Policy Options Generating Equivalent Budgetary Savings in Net Entitlement Costs, Fiscal Years 1995-1999	66
B-2.	Percentage of Recipient Families Losing Benefits Under Three Policy Options Generating Equivalent Budgetary Savings in Net Entitlement Costs, by Family Income and Type	67
B-3.	Distribution of Budgetary Savings Under Three Policy Options Generating Equivalent Budgetary Savings in Net Entitlement Costs, by Family Income and Type	68

B-4.	Average Percentage of Benefits Lost by Families Losing Benefits Under Three Policy Options Generating Equivalent Budgetary Savings in Net Entitlement Costs, by Family Income and Type	69
B-5.	How Three Policy Options Generating Equivalent Budgetary Savings in Net Entitlement Costs Affect the Benefits Lost by Recipient Families, by Program	70

**FIGURE**

1.	Components of Federal Spending as a Percentage of Gross Domestic Product, 1962-2004	1
----	---	---

**BOX**

1.	Measuring the Distribution of Entitlements	8
----	--	---

---

# Summary

**C**urrent projections for the federal budget deficit in the near future show it falling to its lowest level in several years. But the prospects over the longer term are less rosy: if present programs continue as they are, the deficit will begin to rise again toward the end of the decade and reach record levels soon after the turn of the century. As a large and growing share of the budget, spending for entitlement programs is a major contributor to that surge.

To help limit the projected rise in the deficit, some Members of Congress and concerned commentators have proposed scaling back entitlement benefits--specifically, by denying payments (or a share of them) to recipients based strictly on the amount of their incomes. This approach, known as means-testing, has several pluses: straightforward interpretation, simplicity of design, apparent ease of administration, and some political appeal. A related approach, that of considering more benefits as income for tax purposes, has the added advantages of broadening--and therefore improving--the definition of income for purposes of the income tax, and being even easier to administer.

This study examines several ways to means-test entitlements. It describes who gets entitlement benefits, why those people have been designated as beneficiaries, and how alternative approaches to means-testing are likely to affect them. The analysis suggests that several popularly promoted approaches are neither as simple as they appear nor obviously preferable to alternatives in terms of equity.

---

## How Much Is Spent on Entitlements?

Mandatory federal spending for entitlement programs totaled more than \$750 billion in 1993--more than half of the federal budget and up from 30 percent three decades earlier. Outlays for entitlements are projected to grow more than 3 percent faster than the rate of inflation each year for the foreseeable future. By 2004, assuming that present budgetary policy remains in place, entitlements will account for nearly two-thirds of federal spending. The aging of the baby-boom generation will continue to drive that share higher over succeeding decades.

This rapid growth has caused mandatory spending to consume a growing share of the country's output. Since 1962, spending for entitlements as a percentage of gross domestic product has doubled from 6 percent to 12 percent and will exceed 14 percent by early in the next century.

Given the size and growth of entitlement spending, substantial reduction of the nation's budget deficit will almost certainly require bringing that spending under control. Limiting eligibility or reducing benefits program by program is, of course, always an option. But that approach would be both time-consuming and politically difficult. In addition, it could have an uneven impact on recipients, particularly those who receive

benefits from more than one program. A "global" approach, such as making more entitlements subject to federal income taxes or reducing or denying benefits from combinations of programs to recipients with high incomes, is also possible. This study examines several global approaches.

rity, Railroad Retirement, unemployment compensation, veterans' compensation and pensions, and agricultural price supports. (Veterans' pensions are, in fact, means-tested benefits. They are combined here with veterans' compensation because available data do not distinguish between the two programs.) Social Security is by far the largest of these programs, accounting for four-fifths of total outlays in this category.

## What Are the Major Entitlement Programs?

Entitlements can be grouped into four major categories. About half of all entitlement spending goes to *cash social insurance programs*, which include Social Secu-

Just under one-third of the nation's spending for entitlements pays for two *government health insurance programs*--Medicare for elderly and disabled people and Medicaid for the poor. About one-tenth of outlays finance *government pensions* for retired civilian and military employees. Another tenth funds four *means-tested assistance programs* that are designed to aid

**Summary Table 1.**  
**Recipient Families by Income and Type, 1990**

Family Category	Percentage of All Families	Percentage of Families Receiving Benefits	Average Benefits per Recipient Family (1990 dollars)	Percentage of All Benefits
All Families	100	49	10,320	100
Income (1990 dollars) <sup>a</sup>				
1 to 29,999	57	58	9,590	63
30,000 to 99,999	39	37	11,710	33
100,000 or more	4	31	15,220	4
Type <sup>b</sup>				
With children	34	39	8,200	22
Elderly	21	98	13,970	58
Other	45	32	6,930	20

SOURCE: Congressional Budget Office based on data from the Census Bureau's March 1991 Current Population Survey, the Internal Revenue Service's 1990 Statistics of Income, and administrative statistics from individual entitlement programs.

NOTES: Families are groups of related people living together. Individuals not living with relatives are considered one-person families.

The table covers the following entitlements: Social Security and Railroad Retirement, unemployment compensation, veterans' compensation and pensions, Supplemental Security Income, Aid to Families with Dependent Children, the Food Stamp program, the outlay portion of the earned income tax credit, Medicare, Medicaid, and federal civilian and military pensions. Food stamps are measured at face value; Medicare and Medicaid benefits are assigned their insurance value net of any premiums paid.

- Family income comprises all cash income plus the face value of food stamps; it excludes the value of other benefits received in kind. Families with zero or negative income are included only in totals.
- Families with children are all families with at least one member under age 18. Elderly families are all families without children who have at least one member age 65 or older. Other families are all families not in the first two categories.

poor people: Supplemental Security Income (SSI) for the elderly and disabled, Aid to Families with Dependent Children (AFDC), the Food Stamp program, and the refundable portion of the earned income tax credit (EITC).

Of these programs, the Congressional Budget Office (CBO) projects that expenditures for health programs and the EITC will grow most rapidly in the near future. Over the next five years, Medicare and Medicaid costs will rise about 8 percent annually in real terms (after adjusting for inflation) because of rapid inflation in health care costs and growing numbers of participants. Changes made in the Omnibus Budget Reconciliation Act of 1993 will cause spending for the EITC to increase nearly 13 percent annually after adjusting for inflation, but outlays for that program will flatten out by the turn of the century.

---

## Who Gets Entitlements?

In 1990, nearly half of all families in this country received benefits from one or more of 11 major entitlement programs. For recipient families, the value of these benefits averaged about \$10,300 (see Summary Table 1). Because nearly all people over age 65 qualify for Medicare and Social Security, participation in those programs was highest among the elderly; 98 percent received benefits averaging almost \$14,000. As a result, almost three-fifths of all entitlement spending went to families who included at least one member age 65 or older.

About 40 percent of families with children received average benefits of roughly \$8,200, and about one-third of nonelderly childless families got entitlements averaging just under \$7,000. One-fifth of total spending for entitlements went to each of these two groups of families.

Families at the bottom end of the income distribution (low-income families) are more likely to receive entitlements than their wealthier counterparts, but average benefits rise with recipients' incomes. Three-fifths of families with incomes below \$30,000 received benefits from at least one entitlement in 1990 averaging about \$9,600. In contrast, one-third of families with

incomes above \$100,000 got benefits that averaged around \$15,000. In other words, a larger share of low-income than high-income families received benefits but got smaller benefits than higher-income recipients. The net result of these two factors was a distribution of total benefits among categories of income that roughly mirrored the distribution of families among those categories. For example, families with incomes below \$30,000 constituted just under 60 percent of all families and received just over 60 percent of all entitlements (see Summary Table 1).

---

## Approaches to Reducing Entitlement Spending

To reduce spending for entitlements requires cutting the amount of benefits they pay or limiting the number of people who receive them. Such reductions could apply to individual programs--changes made in recent years have taken that approach. Or the cuts could be more global, using some sort of means test to limit spending for most or all programs. Alternatively, the Congress could cut net spending for entitlements indirectly by taxing benefits and thus increasing revenues.

Over the past 15 years, the Congress has limited spending for particular entitlements by reducing cost-of-living adjustments, holding down payments to providers of medical care, and restricting eligibility for benefits. Current legislative proposals would continue this trend by reducing the levels of benefits for future recipients of Social Security and lowering Medicare and Medicaid reimbursement rates for hospitals and medical care providers. Changing individual programs, however, requires considerable time and substantial effort to achieve consensus.

Another approach to curbing the net cost of entitlements would be to broaden the definition of taxable income in the federal individual income tax to include more entitlement benefits. Unemployment compensation and that part of government pensions that exceeds workers' contributions are already fully subject to income taxes, as are part of Social Security benefits for middle- and high-income recipients.

On the one hand, expanding the definition of taxable income to include all entitlements could improve the equity of the income tax by treating income from entitlements like private-sector income. On the other hand, if the Congress set levels of benefits under the assumption that entitlements would not be taxed, subjecting them to taxes could reduce the net benefits that a person receives below what the Congress has deemed appropriate.

A second global approach to reducing entitlements would employ some sort of means test to limit or deny benefits to people with high incomes. Such cuts would impose the costs of this approach to reducing the deficit on those most able to bear them. They would also curtail total payments to people who are receiving benefits from more than one program. This approach might solve the problem of burgeoning entitlements more directly than cuts in individual programs. Nevertheless, it could also keep the programs from achieving the specific goals that they were created to meet.

Which recipients lost benefits would depend on the level of income at which cuts began and the rate at which benefits were taken away as income rose. Setting "thresholds" for those actions at higher levels of income would exempt more current recipients from cuts; reducing benefits at rates that rose more gradually with income or that were limited to less than 100 percent would protect a larger share of benefits. The more benefits are shielded from cuts, however, the smaller will be the budgetary savings.

---

## Budgetary and Distributional Effects of Alternative Policy Options

CBO analysts simulated three specific policy options to show the budgetary savings that taxing or means-testing entitlements might generate. The options that were examined approximate proposals put forth to address the problem of surging entitlement spending. Modifications to each option could raise or lower its budgetary savings.

## Make Entitlements Subject to Federal Individual Income Taxes

The first option would tax benefits that were not attributable to the past contributions of recipients. Entitlement payments subject to federal income taxes under the option would comprise 85 percent of all Social Security and Railroad Retirement benefits, 85 percent of the insurance value of Medicare hospital benefits, the full insurance value of Medicare Supplementary Medical Insurance less any premiums paid, the face value of food stamps, the insurance value of Medicaid, and the full benefits paid for veterans' compensation and pensions, AFDC, and SSI. (The insurance value of Medicare or Medicaid equals the total cost of the program divided by the number of people participating. Counting only 85 percent of Social Security, Railroad Retirement, and Medicare hospital benefits recognizes that recipients paid taxes during their working years to finance part of their benefits. As noted above, unemployment compensation and federal civilian and military pensions exceeding workers' contributions are already fully taxable.)

If this option was implemented for the 1995 tax year, it would generate \$18 billion of additional revenues in fiscal year 1995 and \$258 billion over five years (see Summary Table 2). More than five-sixths of the additional revenues would come from Social Security and Medicare recipients.

The additional taxes from making more entitlements taxable would average 10 percent of benefits for nearly two-thirds of the families who receive entitlements (see Summary Table 3). Five out of six elderly recipients would pay higher taxes, compared with just one-third of recipient families with children. (The difference in those latter proportions reflects two facts: almost all elderly people receive substantial amounts of entitlements, and families with children who get benefits are most likely to be poor and to be getting means-tested assistance--and therefore unlikely to owe taxes.) Of the additional tax revenues, almost half would come from families with incomes under \$30,000. Nearly three-fourths would come from elderly recipients.

Four modifications to the tax option could change both the revenues that the government gained from it and the way the added taxes were distributed among families of various incomes.

- o Excluding a base amount of entitlements for all taxpayers would protect the poorest families from owing taxes (that they might not be able to pay) on those benefits. It would also, however, fully shield high-income families whose benefits fell below that base amount.
- o Establishing a threshold for family income before any entitlements became taxable would exempt low-income families from new taxes without reducing the tax liability of wealthy families.
- o Taxing only a fraction of all entitlements would lessen the impact of this option on all beneficiaries and would exempt only the poorest recipients whose taxable incomes (including countable benefits) were too low to require them to pay taxes.

- o Exempting some entitlements from taxation would reduce the number of families who were affected, protecting families in those programs that were declared exempt.

### Reduce Entitlement Benefits for Middle- and High-Income Recipients

A second option to lower net outlays for entitlements is modeled on a recent proposal of the Concord Coalition. (The coalition is a bipartisan organization headed by former Members of Congress that focuses on fiscal policy.) The option would cut up to 85 percent of benefits on a graduated scale for families with annual incomes above \$40,000. It would index the income brackets for inflation, but the brackets would be the same for families of all sizes.

The option would affect the following entitlements: Social Security and Railroad Retirement, unemploy-

**Summary Table 2.**  
**Estimated Gains in Revenues and Reductions in Spending Under Three**  
**Policy Options to Cut Net Entitlement Costs, Fiscal Years 1995-1999 (In billions of dollars)**

Policy Option	1995	1996	1997	1998	1999	1995-1999
Broaden Definition of Taxable Income to Include Entitlements	18.0	52.6	57.0	62.3	68.1	258.0
Reduce Entitlement Benefits for Middle- and High-Income Recipients <sup>a</sup>	9.4	45.4	42.2	44.9	47.9	189.8
Deny Entitlement Benefits to High-Income Recipients	4.1	10.1	9.3	10.0	10.7	44.2

SOURCE: Congressional Budget Office.

NOTE: The table covers the following entitlements: Social Security and Railroad Retirement, unemployment compensation, veterans' compensation and pensions, Medicare, Medicaid, Supplemental Security Income, Aid to Families with Dependent Children, and the Food Stamp program.

a. This option closely resembles the proposal of the Concord Coalition to reduce spending for entitlements.

ment compensation, veterans' compensation and pensions, SSI, AFDC, the face value of food stamps, and the insurance value of Medicare and Medicaid, minus any premiums paid. Following the Concord Coalition's proposal, federal civilian and military pensions would be exempt from cuts. (The coalition excluded pensions from their plan because pensions are part of the labor contract between the government and its employees and not entitlements in the same sense as the other programs.)

If the option was fully implemented at the beginning of 1995, it would reduce outlays for entitle-

ments by about \$9 billion in fiscal year 1995 and \$190 billion over five years (see Summary Table 2). About 60 percent of the savings would come from reducing Social Security benefits, and 30 percent would come from cutting Medicare.

This option would take away an average of a quarter of the benefits of about one-fifth of all recipients (see Summary Table 3). Families with incomes below \$30,000 would be essentially exempt from cuts; more than half of families with incomes between \$30,000 and \$100,000 and five-sixths of those with incomes above \$100,000 would see their benefits fall. Almost

**Summary Table 3.**  
**Distribution of Losses of Benefits Among Recipient Families Under Three Policy Options to Cut Net Entitlement Costs, by Family Income and Type (In percent)**

Family Category	Recipient Families Losing Benefits	Aggregate Benefits Lost	Benefits Lost by Families Losing Benefits
<b>Broaden Definition of Taxable Income to Include Entitlements</b>			
All Families	64	100	10
Income (1995 dollars) <sup>a</sup>			
1 to 29,999	63	46	8
30,000 to 99,999	64	46	12
100,000 or more	71	8	17
Type <sup>b</sup>			
With children	34	9	5
Elderly	85	73	11
Other	60	18	10
<b>Reduce Entitlement Benefits for Middle- and High-Income Recipients</b>			
All Families	22	100	23
Income (1995 dollars) <sup>a</sup>			
1 to 29,999	c	c	d
30,000 to 99,999	56	54	15
100,000 or more	82	45	71
Type <sup>b</sup>			
With children	20	12	20
Elderly	25	72	23
Other	21	15	22

SOURCE: Congressional Budget Office based on data from the Census Bureau's March 1991 Current Population Survey, the Internal Revenue Service's 1990 Statistics of Income, and administrative statistics from individual entitlement programs.

half of all savings would come from the latter group, whose entitlements would drop by about 70 percent.

Neither the likelihood of suffering cuts in benefits nor the average benefit loss would vary much among different types of families. However, because elderly families receive significantly more entitlement benefits than other groups, they would bear nearly three-quarters of the costs.

Three modifications would change the budgetary savings and the way the option's effects were distributed among categories of recipients.

- o Raising the level of income at which reductions begin would exempt more families from cuts, reduce the size of the cuts for all but the highest-income families, and lower the savings in outlays.
- o Lowering the percentage of benefits cut for families in each category of income would have similar effects.
- o Limiting the maximum cut to less than 85 percent would lessen the option's impact--but only for families at the top of the income distribution.

**Summary Table 3.  
Continued**

Family Category	Recipient Families Losing Benefits	Aggregate Benefits Lost	Benefits Lost by Families Losing Benefits
<b>Deny Entitlement Benefits to High-Income Recipients</b>			
All Families	1	100	77
Income (1995 dollars) <sup>a</sup>			
1 to 29,999	0	0	0
30,000 to 99,999	c	c	d
100,000 or more	29	100	77
Type <sup>b</sup>			
With children	c	c	d
Elderly	2	94	80
Other	1	5	57

NOTES: Families are groups of related people living together. Individuals not living with relatives are considered one-person families.

The table covers the following entitlements: Social Security and Railroad Retirement, unemployment compensation, veterans' compensation and pensions, Supplemental Security Income, Aid to Families with Dependent Children, the Food Stamp program, Medicare, and Medicaid. Food stamps are measured at face value; Medicare and Medicaid benefits are assigned their insurance value net of any premiums paid.

- a. Family income comprises all cash income plus the face value of food stamps; it excludes the value of other benefits received in kind. Families with zero or negative income are included only in totals.
- b. Families with children are all families with at least one member under age 18. Elderly families are all families without children who have at least one member age 65 or older. Other families are all families not in the first two categories.
- c. Less than 0.5 percent.
- d. Too few families would be affected to allow estimation of a statistically meaningful value.

## Deny Entitlements to High-Income Recipients

A final option that approximates recent legislative proposals would deny all entitlements to families with very high incomes. The specific proposal analyzed for this study would phase out entitlements at a rate of 50 percent for single people with 1995 nonentitlement income of more than \$100,000 and couples with incomes above \$120,000. It would take away all entitlements when income exceeded those limits by \$10,000 or more. All dollar values would be indexed for inflation.

If the proposal was applied to the same programs as the benefit reduction option discussed above, it would reduce outlays for entitlements by \$4 billion in fiscal year 1995 and nearly \$45 billion over five years (see Summary Table 2). Roughly three-fifths of the savings would come from Social Security, and another one-third would come from Medicare.

This option would affect only the richest 1 percent of entitlement recipients, taking away an average of three-fourths of their benefits (see Summary Table 3). Even so, less than one-third of all recipients with incomes above \$100,000 would suffer cuts. The reductions would fall most heavily on the elderly, who would account for 94 percent of the total savings. Families with children would essentially be exempt from any loss of benefits because most of those receiving benefits have incomes below the option's threshold for cutting entitlements.

Two modifications could change the savings and distributional impact of this proposal.

- o Lowering the threshold for family income above which benefits could be cut would generate greater savings. Although this change would reduce the benefits of more recipients, a small reduction in the thresholds would still protect low- and middle-income families.
- o Broadening the range of income over which benefits are phased out would lower savings and cushion the effects of the option on families near the upper income limit.

## Issues in Implementing the Options

Taxing entitlements or establishing a global means test would require decisions about how to structure and administer each option. Of the three options, counting entitlements as taxable income would be the simplest to carry out because it would use the existing administrative structures of the Internal Revenue Service (IRS). Each program would send recipients a statement of the benefits provided to them during the calendar year that would be subject to income taxes. In turn, recipients would report those amounts as income on their federal tax returns. Accounting periods, tax units, measurement of means, and tax rates would all be defined by the tax code. These issues become more complicated under the benefit reduction and denial options.

A global means test--either to reduce or deny benefits--could be administered in one of several ways: by the individual agencies that currently administer the entitlement programs, by a single newly created agency that would oversee all entitlements, or by a single existing agency like the IRS. A single agency would have the advantage of having to gather data in only one place to apply a single standard to all of the programs. Using an existing organization would avoid creating a new bureaucracy. Adding to the workload of an existing agency could, however, make it difficult for that organization to carry out its principal functions.

Whether a means test is prospective or retrospective would determine how well programs meet the needs of their participants and how easy or difficult it would be to administer the test. On the one hand, a prospective test, which looks at the income people expect to receive in the near future, would provide a better gauge of need in the period when benefits are paid. But a prospective test would be prone to error and by its nature would require reconciliation to recoup overpayments or make additional payments. A retrospective test, on the other hand, although less likely to misestimate a recipient's resources, could base cuts in benefits on a measure of well-being that poorly assesses current needs.

In applying a means test, a major issue is the choice of the appropriate "unit" (individual, couple, family, or some other). That decision determines which recipients would be affected and how much of their benefits they would lose. It also influences whether people would face incentives to change their living arrangements to avoid losing their entitlements.

Applying a means test to individuals would preclude families' breaking up or forming to keep their benefits, but it might understate or overstate a recipient's well-being by ignoring the resources that are shared within a family. Conversely, basing a means test on family income might offer a better measure of a beneficiary's financial situation. It could, however, induce families to split up to avoid losing their benefits. Constructing family-based measures of resources that take account of differences in the size and composition of families could mitigate any economic incentives to alter a family's makeup.

How resources are measured can also have an effect--on the way benefit losses are distributed among recipients and on the way recipients behave. Broad measures that include both cash and in-kind income and assets might offer the best assessment of well-being, but they could also be more expensive and complicated to obtain and more subject to error than simpler measures. The problems of valuing noncash resources alone could make any all-inclusive measure unworkable. And excluding some forms of income or assets could prove difficult as well--by inducing potential beneficiaries to shift their income and assets into those excluded sources and thus avoid losing their benefits.

The rate at which entitlements are cut as incomes rise affects both the budgetary savings that means-testing would generate and disincentives for beneficiaries to work and save. The higher the rate at which benefits are cut, the greater will be the budgetary savings--but also the more likely people will be to work or save less to avoid losing benefits. How much recipients would respond to the disincentives that means-testing creates is unknown. Their response would depend not only on the rate of benefit reduction but also on the range of resources over which means-testing would apply and the way in which the means test would be administered.

A final implementation issue involves taxing or reducing benefits received in kind from Medicare, Medicaid, and the Food Stamp program. To put any of the three options in place would require assigning monetary values to such benefits, but there is little agreement about how to do that.

CBO's analysis valued food stamps at their face value and Medicare and Medicaid at their insurance value. Yet those amounts, particularly for the health programs, probably overstate the value to many participants of the benefits they receive. And even if policy-makers could agree on how to value in-kind benefits, many beneficiaries, particularly those at the bottom of the income distribution, would lack the financial resources to pay taxes on those benefits.

Furthermore, because reducing health benefits by any given percentage is probably impractical, the benefit reduction option would be likely to assess premiums on the families it affects equal to an appropriate percentage of the value assigned to benefits. Again, some families receiving benefits might be unable to afford those premiums. Each of the options would require features to address these difficulties.

---

## Comparing the Policy Options

The three policy options discussed in this study would differ markedly in several aspects: their budgetary savings, how they would distribute costs among recipients of entitlements, and the problems of administration they would pose. The three options are essentially similar in that they all would impose taxes on entitlements based on a family's entitlement and nonentitlement income. They differ in the tax rates they would impose and the income brackets over which those rates would apply.

Among the three options examined in this study, the tax option would generate the greatest budgetary savings--about \$260 billion in new revenues over five years. It would also affect the most recipients, but it would impose the smallest costs--about 10 percent of benefits--on those families who would pay higher taxes. Because rates in the federal individual income tax are

relatively flat, this option would be the least progressive of those examined. It would, however, be the easiest and probably the least costly to administer: recipients would simply report and pay taxes on their benefits when they filed their federal tax returns.

At the other extreme, the option denying benefits to high-income families would save much less than the other two options--about \$44 billion over five years--because it would affect the fewest recipients. The affected families, however, would lose a greater share of their benefits--about three-fourths--making the denial option the most progressive of the three approaches. Finally, although each affected case would be costly to administer, only 1 percent of recipient families would be involved. Thus, the total administrative costs of this option would be limited.

Reducing benefits that go to middle- and high-income families would produce savings and effects on beneficiaries that fall between those of the other two options. Over five years, the benefit reduction option would save three-quarters as much as the tax option but

more than four times as much as the denial option. On the one hand, it would be more progressive than the tax option, taking more than twice as great a share of benefits away from about a third as many recipients. On the other hand, it would be less progressive than the denial option: on average, it would take away one-third of the share of benefits but would affect more than 20 times the number of families.

The benefit reduction option would be the most costly of the three to administer. Agencies would have to obtain information on the incomes of most recipients, and many cases would require reconciliation of levels of benefits at the end of each year.

Modifying the three options so that they would generate more comparable budgetary savings would reduce the differences among their effects on beneficiaries. Nevertheless, the options would maintain their relative positions in terms of number of families affected, share of benefits lost, progressivity, and cost of administration.